

Client Update

More Than Just Solvency II: Insurance Industry Developments in 2016 So Far

LONDON

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INTRODUCTION

The start of 2016 has already seen significant developments for the UK insurance industry. Perhaps most notably, Solvency II finally came into force on 1 January (see our [Client Update](#) for further details). Here, we highlight the other key insurance developments of the year so far, including statements from the Prudential Regulation Authority (“PRA”) in response to Solvency II’s coming into force, a Financial Conduct Authority (“FCA”) investigation into communications with closed-book customers and the upcoming EU-wide insurance industry stress test.

PRA – SOLVENCY II

The PRA has published various materials since Solvency II came into force, including a speech made by Andrew Bulley, Director of Life Insurance, on the new Solvency II landscape.

Bulley’s [speech](#) was given at the Investment and Life Assurance Group Limited Conference and described Solvency II as a “once in a generation” reform of insurance supervision. Significant transitional measures have been required to make Solvency II work across the different European jurisdictions and harmonisation of capital adequacy calculations is not yet perfected.

The PRA intends to make the transition from ICAS to Solvency II as smooth as possible, maintaining “business-as-usual” supervision and remaining a “forward-looking” regulator. On this basis, and bearing in mind the need to protect policyholders, the PRA will not hesitate to intervene “at an early stage” if it judges that there are sufficient risks and prospective threats to endanger policyholders.

A “second wave” of internal model applications is expected this year, and any model changes requiring approval will be closely scrutinised where the rationale for such a change is clearly to reduce capital requirements. The PRA does not intend insurers to hold much higher capital levels than necessary under the Solvency Capital Requirement; there is to be no introduction of “buffers on buffers”.

Among the other materials published by the PRA were letters on longevity risk transfers and the Solvency II internal model approval process (“IMAP”).

The longevity risk [letter](#) sets out the PRA’s views on issues arising from the risk of policyholders and beneficiaries living longer than expected, and expectations in this area. There is a longstanding active market in transferring longevity risk, and Solvency II may further incentivise firms to transact to transfer this risk through reinsurance. Firms may seek to use longevity risk transfer to reduce their risk margin when calculating technical provisions.

The PRA is concerned that involvement in this market could be for reasons other than genuine risk transfer. Firms are expected to monitor and deal with concentration risks according to Solvency II risk management rules and notify the PRA of longevity risk transfers in advance. Further, firms could consider asking reinsurers to provide collateral as security for their obligations under the transfer to help reduce counterparty risk.

The Bank of England’s Executive Director of Insurance Supervision, Sam Woods (soon to be Deputy Governor for Prudential Regulation and Chief Executive of the Prudential Regulation Authority), issued a [letter](#) reflecting on the 2015 Solvency II IMAP. The “Quantitative Framework” and the Solvency Capital Requirement were the focus. The letter is valuable for the “second wave” of firms submitting internal model applications in 2016, as it brings together information from various 2015 announcements.

FCA INVESTIGATES COMMUNICATIONS WITH CLOSED-BOOK CUSTOMERS

Old Mutual, Prudential, Abbey Life, Scottish Widows, Countrywide and Police Mutual are under investigation by the FCA over concerns of potential failings in communication with closed-book life assurance customers.

The [investigation](#) comes out of a wider thematic review of the fair treatment of longstanding customers at 11 firms. The resulting report noted occasionally poor, and at best patchy, practices in some firms. Particular concern was raised around communications with customers in relation to exit and paid-up charges. The

investigation will focus on whether policyholders were informed of these charges when they were incurred at exit or conversion.

The investigation will focus on the disclosure of exit and paid-up charges to closed-book life assurance customers after December 2008. Old Mutual and Abbey Life are also subject to a broader probe as to whether they complied with additional regulatory requirements in other areas during the same period.

Commencement of an investigation is not to be taken to indicate that it will necessarily result in disciplinary action against the firms involved nor does it indicate that a penalty will inevitably be imposed or that redress will be payable. The FCA noted that depending on the outcome of this action the FCA may extend this work to a wider population of firms, including any of the firms in the thematic review and/or other firms in the life insurance sector.

PRA OUTLINES EXPECTATIONS FOR MODEL CHANGE, RESERVING AND REINSURANCE

Chris Moulder, the PRA's Director of General Insurance, raised various regulatory issues and set out the PRA's expectations in a [speech](#) given on 4 April to the Worshipful Company of Insurers' iNED Forum.

Firms may be considering refining their approved internal models so they continue to reflect the firm's risk profile. Any changes must be properly reviewed and authorised to prevent "model drift", where the capital requirements of a firm begin to trend downwards inappropriately over time. Firms must have a "robust" process for identifying all sources of potential model change; selectively amending the internal model by focusing solely on "conservative" parts in order to reduce capital requirements must be avoided.

The PRA will continue to focus on reserving: the core expectation that firms set adequate technical provisions is unchanged. Further, boards must show independent challenges of material uncertainties and significant assumptions in the reserves as part of their oversight of the reserving process.

In relation to the apparent re-emergence of complex reinsurance arrangements in the market, Moulder recognised that reinsurance is essential for most firms' risk management and is both efficient and effective in reducing volatility. However, the PRA continues to require firms to demonstrate that any resulting reductions to capital requirements are proportionate to the risk actually being transferred.

EU STRESS TESTS

Preparations are underway in advance of EIOPA's EU-wide insurance industry stress tests which are due to launch in May, with a report expected in December 2016.

The PRA announced in February that it was considering which UK firms would take part, stating that it would take into account other activities being undertaken by firms this year.

The stress tests aim to assess the resilience and vulnerabilities of the EU insurance sector in adverse market risk scenarios. The focus will be on a "double hit" scenario where, in addition to low interest rates, asset prices are also stressed.

SMCR IN FORCE

The Senior Managers and Certification Regimes (together, "SMCR") came into force on 7 March. The objective of the regimes is to improve accountability in the financial services sector. Firms should already have notified the FCA or PRA of the names of senior staff to be transitioned into the new regime.

Further analysis of the requirements of the SMCR is available in our [Client Update](#).

PRA LAUNCHES CONSULTATION ON APPLICATION OF SOLVENCY II REMUNERATION REQUIREMENTS

On 7 April, the PRA [published](#) its consultation paper on remuneration requirements under Solvency II, to seek feedback on its draft supervisory statement.

The Solvency II requirements relate to the remuneration of senior staff whose activities have "a material impact on [their firm's] risk profile" and have been in force since 1 January. The PRA's proposed supervisory statement aims to ensure the correct interpretation and consistent implementation of these regulatory requirements.

Under the PRA's current proposals, senior staff could see 40% of variable pay deferred for at least three years, with claw-back possible if failures later come to light.

Responses to the consultation may be submitted until 2 June 2016. Further analysis of the PRA's proposals is available in our [Client Update](#).

PRA FINES QIB FOR CAPITAL ADEQUACY FAILINGS

On 8 April, the PRA [imposed](#) a £1,384,950 fine on QIB (UK) Plc (a UK subsidiary of Qatar Islamic Bank) for significant failings in assessing, maintaining and reporting to the regulator on its financial resources.

Between 30 June 2011 and 31 December 2012, QIB neglected to undertake a regular assessment of its capital as it failed to recognise that it had to comply with requirements around assessment and maintenance of financial resources and capital.

The PRA stressed the importance of regulated firms, including subsidiaries of overseas firms, being aware of, and having systems in place to ensure adherence to, regulatory requirements.

RESPONSES TO THE EC CONSULTATION ON THE EU REGULATORY FRAMEWORK FOR FINANCIAL SERVICES

The European Commission has published a list of responses to its 2015 call for evidence on the EU regulatory framework for financial services.

Among the 287 respondents were insurance trade associations and several insurers, including Legal & General, Swiss Re, Allianz and Crédit Agricole. The consultation provided an opportunity for insurers to comment on their experience implementing recent legislation affecting them and on the EC's steps to diversify investment opportunities for insurers.

In its [response](#), the Association of British Insurers called for regulatory consistency, longer implementation periods and more progress in defining infrastructure investment as a separate asset class.

HM Treasury and the Bank of England also published their responses. HM Treasury's [response](#) emphasised the fact that effective implementation of the financial stability regime is being hindered by inconsistencies across the large quantity of EU legislation introduced since 2008. Additionally, a proportionate approach to regulation, with different requirements for smaller and less complex firms, was suggested.

The Bank of England's [response](#) highlighted areas for possible adjustment, with its principal focus on the banking sector.

A summary of all the responses is expected at a later date.

PRA UPDATES ITS APPROACH TO INSURANCE SUPERVISION

On 11 March, the PRA published its updated [approach to insurance supervision](#), replacing the previous 2014 version. The update contains no significant unexpected developments, with the majority of changes (listed in the annex to the statement) reflecting the coming into force of Solvency II.

The appropriate protection of policyholders remains at the forefront of the PRA's objectives, so the document sets out the threshold conditions and fundamental rules that firms are required to meet.

New material in the updated document includes the PRA's secondary objective concerning promoting effective supervision, the PRA Rulebook and the senior insurance managers regime.

The PRA also highlights its cooperation with foreign insurance supervisors and the International Association of Insurance Supervisors. For overseas insurers operating in the UK, the PRA's supervisory approach will depend on whether the firm is a UK subsidiary or branch of an overseas insurance group and whether the group is an EEA insurer, and if not, whether the third country is a Solvency II equivalent jurisdiction.

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Please do not hesitate to contact us with any questions.